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FINANCIAL LIBERALIZATION IN JAPAN: UPDATE AND IMPACT

Summary

Japanese financial institutions have become a significant force in global finance over the past several years thanks in large part to the cumulative impact of the Ministry of Finance's incremental approach to liberalization and reform of Japan's financial system. Now that the relatively easy changes have been made, however, the strategy faces two supreme tests: reforming the giant postal savings system and amending Article 65 of the Securities and Exchange Law that separates banking and securities operations.

While the Finance Ministry tackles these two issues, domestic and foreign companies will take full advantage of the past reforms to integrate Japan's financial network with the European and U.S. markets. This report reviews last year's changes, previews moves scheduled for this year and analyzes the impact of financial freedom on Japanese financial behavior.

A Brief Look Back

The process of eliminating the government's strongest financial controls and restrictions, which began in the late 1960s, culminated in the passage of a new foreign exchange control law in 1980. At that time external transactions were freed in principle, while key domestic markets remained firmly, if subtly, controlled (see JEI Report No. 10A, March 9, 1984). Companies did not take advantage of their new freedom, however, for fear of falling out of the Finance Ministry's favor if foreign activities were deemed undesirable. Since domestic

operations formed the vast bulk of day-to-day transactions, it is not surprising that Finance retained a great deal of influence.

The key to putting real impetus behind financial change was the May 1984 report of the Joint Japan-U.S. Ad Hoc Group on Yen/Dollar Exchange Rates, Financial and Capital Market Issues. The accord, worked out by then-Treasury Secretary Donald Regan and then-Finance Minister Noboru Takeshita, produced a series of immediate changes and promised a host of others (see JEI Report No. 22B, June 8, 1984) in three broad areas:

Yen internationalization - To increase the yen's role in international markets the real-demand rule and limits on currency swaps were eliminated, allowing speculative foreign exchange trading; regulations restraining the Euroyen market were eased; and a yen-denominated bankers' acceptance market (necessary if more trade was to be denominated in yen) was slated for opening in 1985.

Interest rate decontrol - The gradual decontrol of interest rates on deposits was intended to increase the role of free market mechanisms and to improve the returns to savers. By introducing new instruments, such as money market certificates and large time deposits, and lowering the minimums on existing instruments that paid market rates (certificates of deposit, for example), the Finance Ministry hoped to gradually bring Japanese markets more into line with those in New York and London.

Institutional restructuring - The strict compartmentalization of Japanese financial institutions that characterized the postwar system was scheduled for reform via a highly unusual route: greater access for foreign financial institutions. The first step was to allow foreign commercial banks to start trust banking operations, a move Japanese commercial banks were barred from making. Foreign institutions were also given greater opportunities to participate in domestic and Euroyen bond markets.

Between 1985 and 1987 the government gradually addressed other areas of concern to domestic and foreign interests while continuing to implement the 1984 report. The most significant developments are summarized below:

- The withholding tax on Euroyen instruments held by nonresidents was repealed January 30, 1985. Foreigners had complained that the tax made the instruments unattractive, hampering yen internationalization efforts.

- A short-term government bond market was opened April 1, 1985 to broaden the maturity structure of government debt and to provide another tool to monetary officials.

- Securities houses were allowed to trade certificates of deposit starting June 1, 1985, joining the 13 banks originally authorized in March.

- A government bond futures market was established October 15, 1985 to support the new market for short-term government bills.

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• The first of six foreign securities firms admitted to the Tokyo Stock Exchange in late 1985 began trading in early 1986. Included among the six were three American companies: Merrill Lynch International Bank, Inc., Goldman Sachs International Corp. and Morgan Stanley International Ltd.

• Finance officials issued new capital ratio guidelines requiring a bank's net-worth-to-total-asset ratio to reach 4 percent by the end of fiscal 1986. In addition, accounting methods for loan guarantees and loans to subsidiaries were tightened. Both moves responded to fears that Japanese banks were undercapitalized compared to their foreign competitors.

• Small and medium-size securities companies were allowed to singly or jointly manage investment trusts in May 1986, and the ceiling set semiannually on new investment trusts was dropped in July. The changes allowed "spot trusts," which can be quickly opened and closed to take advantage of changing market conditions, to proliferate.

• Insurers were allowed to offer variable life insurance beginning in October 1986. The insured amount and the amount paid if the policy is cancelled vary in line with the performance of the underlying investments. Since most insurance companies invest in stocks and bonds, variable insurance policyholders saw returns of 27 to 54 percent in 1986 compared with a 7 percent yield on standard insurance policies. Not surprisingly, the new policy has proved very popular.

• Regulations covering the booming investment advisory business were adopted November 26, 1986. As investment options proliferated, individual investors sought professional advice and were occasionally victims of fraud.

• The Tokyo International Banking Facility opened December 1, 1986 to lukewarm commercial interest. While the government hoped the new offshore banking facility would draw foreign capital like the New York and London facilities, taxes and regulations made it relatively unattractive.

The pattern of changes is instructive: initially liberalizing overseas activities in turn created pressure for domestic change. The bond market presents the clearest example. The Euroyen market was almost completely liberalized by mid-1986, while the home market suffered from various taxes and rigid flotation requirements and procedures. Not surprisingly, Euroyen bond activity was intense while domestic borrowing fell off sharply. Domestic regulations were eased in 1986 in an effort to revitalize the home market.

The Ministry of Finance continued to stretch the boundaries between commercial and investment banking by allowing foreign bank holding companies to open securities brokerages or advisory offices. Domestic banks and securities companies were also allowed to compete head-to-head in new markets, for example, certificates of deposit and bond futures. The two groups were also able to compete more strenuously for investor funds -- commercial banks by offering new savings instruments with market-determined rates, trust banks by offering accounts that granted them wide investment decision powers leading hopefully to higher returns, and securities houses through such tools as "sweep" accounts, which also promised higher returns in exchange for trading freedom.

1987 Recap

The Finance Ministry took the following actions in 1987:

- Trading of Japanese government bond futures was initiated on the London International Financial Futures Exchange on July 13 and on the Chicago Board of Trade in November, opening the way for round-the-clock trading of this instrument.

- Regulations limiting the amount of foreign holdings in trust and insurance company portfolios were liberalized as part of an effort to support the dollar and keep capital flowing to the United States.

- Interest rate decontrol advanced twice during the year. On April 1 the issue ceiling (amount outstanding compared to stockholders' equity) for certificates of deposit was raised to 300 percent from 250 percent; the issue ceiling for money market certificates was similarly increased. At the same time, maturities on money market certificates, which start at one month, were lengthened from one to two years. Moreover, the minimum size for MMCs was reduced to Y20 million ($160,000 at Y125=$1.00) from Y30 million ($240,000), and the minimum unit for large time deposits paying market rates was lowered from Y300 million ($2.4 million) to Y100 million ($800,000). Then on October 5 the issue ceiling for both instruments was abolished; the minimum money market certificate was lowered to Y10 million ($80,000); and the minimum term for a large deposit was reduced from three months to one month.

- The Ministry of Finance widened its unofficial policy allowing foreign banks to enter the securities market on June 3. European universal banks already operated brokerage offices, but American banks were now permitted to open joint venture securities firms with a nonfinancial company as long as their interest did not surpass 50 percent.

- On June 9 the Osaka Stock Exchange slipped around regulations barring stock futures by offering a futures contract based on a basket of 50 issues traded on the Tokyo Stock Exchange rather than the entire Nikkei 225 Average. The fact that the government allowed this encouraged the exchange to begin planning its own quasi-futures option.

- The minimum unit on the bankers' acceptance market was reduced from Y100 million ($800,000) to Y50 million ($400,000) on May 11, and the maximum settlement period was extended from six months to one year.

- Foreign participation in the primary government bond market was expanded by eliminating the requirement that foreign members of the bond-buying consortium open a special account with the Bank of Japan in order to bid directly at auctions (June). Additionally, the share of each placement allocated to foreign firms was raised from 1.19 percent to 5.7 percent (June), and an open auction system for 20-year bonds was instituted (November).

- Membership in the Tokyo Stock Exchange was broadened by 21 seats October 20, and the new members were announced December 16. Including one seat vacated due to a merger, six Japanese and 16 foreign firms won trading positions, including six American, four British, and two each from France, West

Germany and Switzerland. The new members will begin trading in mid-1988 when the exchange moves into new, larger facilities.

• A special panel to study the problem of insider trading was inaugurated October 19 in response to a bond futures trading scandal that rocked markets.

• A commercial paper market began operating November 20 with 178 companies eligible to float offers. With the minimum size set at Y100 million ($800,000) and the interest rate pegged well below CDs, the market was expected to prove only moderately attractive. Nonetheless, at least 30 companies had issues out by the end of the year. At the same time, foreign companies were allowed to issue yen-denominated commercial paper in Europe in another bid to increase the international use of the yen.

Three other important events took place in 1987:

• The postal savings system established a fund management division on May 29 as the first step in its transformation from a simple depository to a provider of full banking services. In return for supporting the abolition of tax-exempt small savings accounts (which make up the majority of postal savings deposits) as outlined in MOF's tax reform plan, the Ministry of Posts and Telecommunications demanded the right to sell government bonds over the counter at its 19,000 post offices. The new division's initial assets amounted to Y2 trillion ($16 billion), with additions of Y500 billion ($4 billion) planned annually up to a total of Y15 trillion ($120 billion). It is required for now to put half the funds into government bonds and the other half into foreign government bonds and blue-chip securities. Eventually, however, the division hopes to invest its portfolio as it sees fit. Japanese banks are very concerned about the postal savings system, especially since the postal authorities hope to offer loans and other investment instruments. With six times as many offices as the largest nationwide commercial bank, the postal savings system would be a formidable competitor.

• The Financial System Research Council submitted a report on the restructuring of the domestic banking industry December 4, calling for changes in four areas: foreign exchange transactions, sogo or mutual banks, long-term credit banking and trust banking (see JEI Report No. 46B, December 11, 1987). The basic thrust would be to eliminate the barriers between these fields, increasing merger and competitive possibilities. Only the first two changes are favored by all parties; sharp divisions emerge in debates on the latter two. Present long-term and trust banks want to preserve their privileges, while commercial banks seek an end to the barriers. The Finance Ministry will appoint several advisory committees in 1988 to study implementation measures.

• Tokyo joined in a landmark international agreement on bank capital adequacy ratios after more than a year of talks (see JEI Report No. 47B, December 18, 1987). The Bank for International Settlements announced December 10 that banks of the 10 industrialized nations will be held to the following guidelines by 1992: "core capital" (equity and retained earnings) must equal at least 4 percent of total risk-weighted assets and this ratio must reach 8 percent when secondary capital is included. Japanese banks will be allowed to include 45 percent of their unrealized stock gains in secondary capital, less than the 75 percent Tokyo had lobbied for but better than the total exclusion

sought by American and British officials. In any case, with current ratios between 2 percent and 3 percent, Japanese banks must raise a monumental amount of capital over the next four years.

The Impact

Not surprisingly, these changes have revolutionized both individual and corporate financial behavior. In classic textbook fashion, investors have demanded higher and higher returns as a wider range of options has become available. Zaitech, a term meaning financial technique, swept Japan as stock and bond markets rose to new highs. The October 1987 crash of equity markets around the globe, however, served as a reminder that greater yields mean greater risks. Although chastened somewhat, Japan remains bullish on its financial future.

• Individuals - Zaitech in this case meant diversifying into stocks, mutual fund-like instruments, deposits paying market rates and variable life insurance (see Table 1). According to the Bank of Japan's flow of funds data for the second quarter of 1987, individuals reduced their position in time and demand deposits (which pay fixed, very low rates) and traditional trust accounts in favor of more lucrative instruments. Certificates of deposit more than doubled from year-earlier levels of Y1.8 trillion ($14.4 billion) to Y3.7 trillion ($29.6 billion); securities investment trusts skyrocketed from Y1.8 trillion ($14.4 billion) to Y4.2 trillion ($33.6 billion); stock holdings leapt to Y347 billion ($2.8 billion) from Y55 billion ($440 million); and insurance investments rose from Y1.2 trillion ($9.6 billion) to Y1.8 trillion ($14.4 billion).

It is clear that Japanese savers have shown little hesitation about new instruments, and banks, securities companies and other financial institutions have provided a flood of new offerings. As far as equities are concerned, however, the stagnation of the Tokyo Stock Exchange in the aftermath of the global crash has dampened enthusiasm. (The failure of the price of Nippon Telegraph and Telephone Corp.'s shares to return to their historical highs has been particularly discouraging.) Thanks to better regulation of the investment advisory industry, the entry of foreign firms into the field, and government steps to guarantee certain instruments, individual investors remain eager customers.

• Nonfinancial corporations - Corporate finance managers have responded enthusiastically to the new environment. Thanks to record profits over the past several years, they have sought greater returns on their cash funds (see Table 2). Tokkin, or specified fund trusts, have been one of corporate zaitech's most important tools. The investor instructs the broker to trade only in a certain category of companies (biotechnology firms, for example). While strictly speaking the broker should ask the customer's permission to make a trade, in practice the broker has blanket permission to buy and sell. Corporate funds flowing into stocks jumped to Y403 billion ($3.2 billion) in the second quarter of 1987 compared with Y74 billion ($592 million) the previous year. Certificates of deposit also increased in popularity -- up to Y7.2 trillion ($57.6 billion) compared to Y3 trillion ($24 billion). Not everyone is convinced of zaitech's benefits, however. According to a February 1988 survey by the Japan Chamber of Commerce, 64 percent of the respondents had company policies prohibiting the active trading of stocks, bonds, real estate and gold.

Table 1: Japanese Personal Savings by Repository

(end of period in trillions of yen and percentage of total)

Fiscal Year	Savings and Deposits						Trusts	Insurance	Stocks	Total
	Total	Banks	Sogo Banks	Credit Unions	Postal Savings	Other				
1975	Y106.5	Y38.1	Y9.1	Y13.8	Y24.6	Y20.9	Y8.9	Y22.6	Y16.6	Y154.6
Share	68.9%	24.6%	5.9%	8.9%	15.9%	13.5%	5.8%	14.6%	10.7%	100.0%
1980	207.9	66.7	16.6	25.2	62.0	37.4	16.9	49.0	34.1	307.8
Share	67.5%	21.7%	5.4%	8.2%	20.1%	12.2%	5.5%	15.9%	11.1%	100.0%
1981	234.1	74.3	18.5	28.0	69.6	41.1	18.4	56.3	37.5	343.7
Share	67.3%	21.6%	5.4%	8.1%	20.3%	12.0%	5.4%	16.4%	10.9%	100.0%
1982	252.5	80.0	19.8	30.1	78.1	44.4	21.1	64.8	42.3	380.9
Share	66.4%	21.0%	5.2%	7.9%	20.5%	11.7%	5.5%	17.0%	11.1%	100.0%
1983	272.2	85.4	21.1	32.1	86.3	47.3	23.4	74.1	50.5	420.2
Share	64.8%	20.3	5.0%	7.7%	20.5%	11.3%	5.6%	17.6%	12.0%	100.0%
1984	294.2	93.2	21.6	34.6	94.0	50.7	25.1	84.6	57.1	461.0
Share	63.8%	20.2%	4.7%	7.5%	20.4%	11.0%	5.4%	18.3%	12.4%	100.0%
1985	318.0	100.7	22.9	37.1	103.0	54.3	26.5	97.9	61.1	503.5
Share	63.2%	20.0%	4.5%	7.4%	20.5%	10.8%	5.3%	19.4%	12.1%	100.0%
1986	339.6	109.7	23.4	39.5	109.5	57.3	27.4	116.4	70.9	554.3
Share	61.3%	19.8%	4.2%	7.1%	19.8%	10.3%	4.9%	21.0%	12.8%	100.0%
1987: I	345.6	112.3	23.6	39.9	112.8	57.0	27.7	89.9	78.6	618.6
Share	55.9%	18.2%	3.8%	6.5%	18.2%	9.2%	4.5%	14.5%	12.7%	100.0%

Source: Bank of Japan

Table 2: Uses of Japanese Corporate Funds

(in billions of yen and percentage of total)

	Average 1975-79	Average 1980-84	1982	1983	1984	1985	1986
Cash and demand deposits	Y2,509.9 30.5%	Y1,177.8 9.6%	Y1,510.6 12.7%	Y-432.3 -3.5%	Y2,058.4 12.4%	Y1,235.5 4.9%	Y4,808.2 14.2%
Time deposits	3,219.9 39.2%	4,333.4 35.2%	3,971.3 33.3%	6,451.7 52.1%	3,198.8 19.3%	8,791.6 34.5%	10,213.1 30.1%
Certificates of deposits	251.8 3.1%	1,080.8 8.8%	784.2 6.6%	984.1 8.0%	2,273.0 13.7%	758.6 3.0%	696.8 2.1%
Trusts	497.8 6.1%	540.7 4.4%	287.7 2.4%	552.8 4.5%	1,378.9 8.3%	2,484.3 9.8%	6,697.7 19.8%
Securities	1,049.8 12.8%	2,108.6 17.1%	2,443.2 20.5%	1,903.5 15.4%	1,546.6 9.3%	2,214.3 8.7%	2,340.2 6.9%
Bonds	594.3 7.2%	1,404.9 11.4%	1,570.6 13.2%	1,367.1 11.0%	750.2 4.5%	1,690.9 6.6%	-500.5 -1.4%
Stocks	442.5 5.4%	641.8 5.2%	852.2 7.1%	386.2 3.1%	641.9 3.9%	474.1 1.9%	353.8 1.0%
Investment trusts	13.0 0.2%	62.0 0.5%	20.6 0.2%	150.2 1.2%	154.6 0.9%	49.3 0.2%	2,486.9 7.3%
Foreign credit	689.6 8.4%	3,058.2 24.9%	2,942.9 24.6%	2,915.9 23.6%	6,161.0 37.1%	9,975.6 39.2%	9,134.6 26.9%
Total	8,218.9 100.0%	12,299.4 100.0%	11,939.9 100.0%	12,375.7 100.0%	16,616.7 100.0%	25,459.9 100.0%	33,890.6 100.0%

Source: Bank of Japan

Even among the 34.2 percent engaging in zaitech, 33.4 percent reduced their exposure after the October crash.

On the other side of the coin, it is unclear whether companies have shifted fundraising strategies away from traditional bank borrowing in favor of stock and bond issues as might be expected. According to MOF data on the one hand, nearly two-thirds of the new funds raised by all industries in FY 1980 came from bank borrowings, with stock issues accounting for another 23 percent. By fiscal 1986 the share of bank loans had fallen to 9.1 percent, while stock issues rose to 37 percent and convertible bond issues accounted for another 30 percent. On the other hand, Bank of Japan data show the opposite: loans from private banks have steadily increased their dominance (see Table 3). The figures do show, however, that borrowing from all domestic sources has been stagnant over the past decade, while the share of securities has grown sharply. The surge in foreign currency bond flotations is particularly interesting, perhaps indicating that overseas needs are being met with overseas funding.

- Financial institutions - Driven by the need to offer higher returns, financial institutions have aggressively pursued new opportunities opened by liberalization. While both banks and securities companies are expanding overseas, competition in the home market continues to heat up.

New bank offerings have been fairly successful in attracting deposits. Bank of Japan statistics show that in October 1987 all banks reported Y9.9 trillion ($79.2 billion) in certificates of deposit compared with Y8.4 trillion ($67.2 billion) the previous year, Y11.7 trillion ($93.6 billion) in money market certificates versus Y6 trillion ($48 billion), large deposits worth Y39.8 trillion ($318.4 billion), well above the Y14.1 trillion ($112.8 billion) level of October 1986, and trust accounts up from Y12.2 trillion ($97.6 billion) to Y13.3 trillion ($106.4 billion). While debentures continued to play a major role in funding (the total rising to Y37.8 trillion or $302.4 billion from Y36.2 trillion or $289.6 billion), convertible bond issues exploded from Y186.8 billion ($1.5 billion) to Y686.1 billion ($5.5 billion). All told, liabilities rose from Y421.6 trillion ($3.4 trillion) in October 1986 to Y459.7 trillion ($3.7 trillion) a year later.

On the other side of the balance sheet, banks have taken advantage of higher interest rates and rising stock markets. Deposits with other banks were up from Y8.1 trillion ($64.8 billion) to Y10.5 trillion ($4 billion) in the year ending October 1987; CD holdings rose from Y392 billion ($3.1 billion) to Y1.1 trillion ($8.8 billion); corporate bonds climbed to Y17.3 trillion ($138.4 billion) from Y16.5 trillion ($132 billion); stocks went up Y2.8 trillion ($22.4 billion) for a total of Y15 trillion ($120 billion); and foreign security portfolios hit Y10.6 trillion ($84.8 billion), up from Y9.1 trillion ($72.8 billion).

Securities companies enjoyed strong growth from October 1986 to October 1987, with total assets jumping 43.2 percent to Y25.5 trillion ($204 billion). While all components rose, margin trading accounts climbed from Y4.5 trillion ($36 billion) to Y7.2 trillion ($57.6 billion), with the growth of customer securities holdings rising to Y12.5 trillion ($100 billion) from Y8.7 trillion ($69.6 billion). On the liabilities side, the biggest increases were in margin accounts, which went from Y900 billion ($7.2 billion) to Y1.5 trillion ($12

Table 3: Sources of Japanese Corporate Funds

(in billions of yen and percentage of total)

	Average 1975-79	Average 1980-84	1982	1983	1984	1985	1986
Domestic borrowings	Y12,381.3 83.9%	Y18,623.1 85.7%	Y19,097.5 84.2%	Y19,174.2 86.6%	Y20,863.3 84.8%	Y23,771.1 81.6%	Y26,295.0 82.6%
Private	10,679.0 72.3%	16,680.4 76.8%	16,817.5 74.2%	17,588.6 79.4%	19,533.6 79.4%	22,761.0 78.1%	25,741.3 80.8%
Banks	6,184.6 41.9%	11,318.20 52.1%	11,835.3 52.2%	12,489.8 56.4%	15,167.8 61.6%	18,914.7 64.9%	20,654.9 64.8%
Other	4,494.3 30.4%	5,362.2 24.7%	4,982.2 22.0%	5,098.8 23.0%	4,365.8 17.8%	3,846.3 13.2%	5,086.4 16.0%
Public	1,702.3 11.5%	1,942.7 8.9%	2,280.0 10.1%	1,585.6 7.1%	1,329.7 5.4%	1,010.1 3.5%	553.7 1.7%
Securities	2,249.2 15.2%	3,266.3 15.0%	3,570.2 15.7%	2,952.7 13.3%	4,128.2 16.8%	4,618.6 15.9%	5,344.5 26.8%
Corporate bonds	849.2 5.8%	680.4 3.1%	632.5 2.8%	298.6 1.3%	857.7 3.5%	681.9 2.3%	1,579.7 5.0%
Stock	1,138.6 7.7%	1,763.3 8.1%	2,045.2 9.0%	1,368.1 6.2%	1,850.3 7.5%	1,590.5 5.5%	1,177.1 3.7%
Foreign currency bonds	261.3 1.8%	822.5 3.8%	892.5 3.9%	1,286.0 5.8%	1,420.2 5.8%	2,346.2 8.1%	2,587.7 8.1%
Foreign borrowings	131.1 0.9%	-165.2 -0.8%	7.6 0.0%	27.1 0.1%	-379.6 -1.6%	739.0 2.5%	202.9 0.6%
Total	14,761.6 100.0%	21,724.2 100.0%	22,675.3 100.0%	22,154.0 100.0%	24,611.9 100.0%	29,128.7 100.0%	31,842.4 100.0%

Source: Bank of Japan

billion), and short-term borrowings, which grew from Y2.7 trillion ($21.6 billion) to Y3.6 trillion ($28.8 billion).

Beyond the numbers is a new global strategy. Staff and capital expansion in New York and London has taken place at a rapid rate and is likely to keep on growing. Initially the customers are large institutions and corporations to whom small differences in interest rates mean big money. Japanese firms have established links with Wall Street firms to learn about the American market while offering a window on Japan in return. No less than three (a fourth is pending) Japanese firms are eligible to participate in the primary market for U.S. government securities, an elite circle indeed. Japanese banks are gradually moving into retail operations here, but progress has been slow (see JEI Report No. 3A, January 22, 1988). In Europe Japanese securities firms dominate the Euroyen market and are making steady inroads into the overall market. Japanese firms have taken advantage of "universal" banking laws in Britain, West Germany and Switzerland to gain experience in new fields (security firms in banking and vice versa). Altogether, these actions translate into an aggressive strategy to use the strong yen and Japan's large current account surpluses to build a major presence in global finance.

1988 Preview

It would not be surprising if the Ministry of Finance put its liberalization plans on hold in the face of the global stock market crash and 1987's exchange rate volatility. Instead, it is considering accelerating the process to give companies more elbow room to deal with changing conditions. At present the following changes are planned for this year:

- A full-fledged futures market will be opened in June, although a firm date has not been set. While bond and quasi-stock futures have been introduced, a compromise between banks and securities firms was necessary to allow this development. Unlike New York and London, Japan will have two distinct futures markets. Futures for foreign government bonds and stock indices will be added to the existing yen bond futures market on the Tokyo Stock Exchange. Trading in government bond futures will be based on a fictitious 100-yen standard 20-year bond with a coupon of 6 percent, a minimum face value unit of Y100 million ($800,000), and maturities of three, six, nine, 12 and 15 months. The new trading instrument will resemble present trading of 10-year bonds in two ways: prices will fluctuate a maximum of Y2 (1.6 cents) a day; and margin rates and broker commissions will be identical (a 3 percent margin on deals of at least Y6 million or $48,000 and an additional 0.015 percent brokerage fee on transactions of less than Y500 million or $4 million). A new market for currency, interest rate and other futures will also be created.

In a twist, however, securities firms will be allowed to trade all futures except spot currency options, while bankers will be able to trade in all stock exchange markets but the Tokyo stock futures. This division was maintained to placate the bankers, who consider foreign exchange their territory, and the brokers, who consider stocks their turf. Insurance companies will be given the same trading rights as banks out of consideration for their large foreign holdings.

- Specified trust (Tokkin) accounting rules were eased January 5 to counter bearish sentiment among trust and insurance companies managing the

special trusts. In essence, the government will allow managers to avoid reporting Tokkin losses due to the October 1987 stock market crash.

• The Bank of Japan set new loan guidelines January 14 in an effort to strengthen its control of the money supply. Banks have been raising as much as 40 percent of their new funds on the open market rather than on the call and bill markets where the central bank's influence is strong. Points will be assigned inversely according to the proportion of open market funds raised -- the more the open market is used, the fewer points will accumulate. Each bank's point total will determine its credit line with the central bank, a powerful incentive to reduce open market borrowing.

• City or nationwide commercial banks will be allowed to issue convertible bonds sometime this spring. This is tantamount to issuing long-term debentures, effectively eroding the wall between commercial and long-term credit banks. The change will reduce the cost of borrowing for commercial banks and will allow them to better match asset and liability maturities.

• Following the recommendation of the Financial System Research Council, the Finance Ministry is preparing to allow sogo or mutual banks to change to commercial status, perhaps as early as April. Many of these banks are as large as the regional commercial banks, but the change may trigger a wave of mergers and acquisitions.

• Foreign governments and international organizations such as the World Bank will be allowed to issue yen-denominated bonds in Japan through private placement with a maturity of four years, compared with the current minimum of five years.

• An advisory body to the Justice Ministry has recommended that limits on corporate bond issues be eliminated. Currently the Commercial Law sets ceilings on the amount of straight, convertible and foreign bonds a corporation may have outstanding at any time. The limits may be replaced with simple business performance criteria.

• Foreign companies listed on Japanese stock exchanges will be allowed to issue yen-denominated commercial paper this spring. Foreign reaction to this "samurai" paper has been lukewarm because of restrictive procedures and taxes.

• The Ministry of Finance hopes to introduce legislation to the current Diet session to allow shelf registration of domestic stocks and bonds. In contrast to the present approval system, which takes up to 30 days, shelf registration would allow a firm to make stock or bond offerings up to the registered limit with just one or two days' notice. The faster process will allow equity issuers to take advantage of market developments. The registration would last from one to two years.

• To comply with the Bank for International Settlements' capital ratio guidelines, Japanese banks are expected to offer up to Y2 trillion ($16 billion) worth of new issues. Market analysts are worried that the domestic and Euro markets will be unable to absorb the funding operations, particularly since the crash.

Farther Down The Road

The incremental approach adopted by the Finance Ministry has so far proved equal to the task of restructuring Japan's financial system without undue chaos, and it will continue to be employed to address some of the problems down the road. For example, the restructuring of the banking industry will be pursued piecemeal, as indicated by the decision to allow mutual banks to switch to commercial bank status. The decompartmentalization of foreign exchange banking is also likely to take place before Finance's advisory committees finish work on the deregulation of trust and long-term credit banking. Although these last two subjects are more sensitive, the step-by-step process is being used to weaken existing laws. The decision to allow nationwide commercial banks to float convertible bonds is a clear erosion of the prerogatives of long-term credit banks.

The adoption of new financial regulations and standards will also be addressed on an ad hoc basis. Moves to regulate the investment advisory industry and crack down on insider trading clearly indicate that MOF prefers to deal with problems as they arise rather than try and restrict activities before the fact. This is not the same as laissez faire, however. The quick action to address the need for new accounting and capital ratio standards is a clear message that rules will be imposed when and where necessary.

But some major issues are likely to prove difficult to resolve incrementally. A prime example is the complete deregulation of interest rates paid on deposits. With the easy steps taken, MOF now must find a way to extend the popular deregulation program to small deposits (less than Y10 million or $80,000) (see Table 4). This step affects not only private financial institutions but the giant postal savings system as well. The Ministry of Posts and Telecommunications is eager to join the liberalization process -- but on its terms. Postal officials want to offer money market certificates in units as small as Y100,000 ($800), well below the current Y10 million ($80,000) level and easily within the reach of all savers. This is too drastic in the opinion of the Finance Ministry and private banks; the cost of deposits would skyrocket since banks would have to offer a similar instrument. And the postal savings system would become a tremendously powerful competitor, a development that neither banks nor securities firms relish. The Ministry of Finance has countered by suggesting a gradual reduction of the minimum denomination coupled with an interest rate pegged well below the return on larger certificates and other market-rate instruments. The battle between the two powerful ministries is likely to result in much more freedom for the postal savings system, but at a slower pace than postal authorities would like. From the Finance Ministry's viewpoint, however, the changes will be abrupt compared to previous reforms.

Amending Article 65 of the Securities and Exchange Law is the second problem. Modeled after the U.S. Glass-Steagall Act, the law separates commercial banking and securities operations. While the government favors substantially reducing the barriers between these two fields, it is under heavy pressure from bankers and brokers. Both want access to the other's business but jealously guard their own privileges, although banks are more interested in opening brokerage firms than vice versa. The stock market boom and greater freedom to offer innovative investments has meant record profits for the securities industry -- profits brokers are understandably reluctant to share.

Table 4: Trends in Market-Rate Bank Deposits in Japan

(in billions of yen and percentage share)

	Total Deposits*	Market-Rate Deposits						
		Large Time Deposits	Money Market Certificates	Non-Residents' Yen Deposits	Foreign Currency Deposits	Certificates of Deposit	Total	Share
1975	Y92,921.3	--	--	[Y2,591.7] 100.0%		--	Y2,591.7 100.0%	2.8%
1980	152,978.3	--	--	1,137.9 11.8%	6,577.0 68.2%	Y1,931.1 20.0%	9,646.0 100.0%	6.3%
1981	171,418.5	--	--	1,260.0 10.7%	7,863.0 66.7%	2,674.0 22.7%	11,797.0 100.0%	6.9%
1982	183,576.8	--	--	1,337.0 9.6%	8,953.1 64.5%	3,581.1 25.8%	13,871.2 100.0%	7.6%
1983	199,507.9	--	--	1,349.3 7.7%	11,622.8 66.1%	4,612.4 26.2%	17,584.5 100.0%	8.8%
1984	218,242.0	--	--	1,987.9 8.6%	13,934.4 60.2%	7,210.7 31.2%	23,133.0 100.0%	10.6%
1985: I	227,701.8	--	--	2,050.6 8.1%	16,205.1 63.7%	7,188.2 28.3%	25,443.9 100.0%	11.1%
II	225,649.9	--	Y2,384.8 8.4%	1,947.7 6.8%	14,904.8 52.3%	9,273.2 32.5%	28,510.5 100.0%	12.6%
III	235,407.7	--	2,934.0 9.4%	2,408.8 7.7%	17,415.2 55.6%	8,577.1 27.4%	31,335.1 100.0%	13.3%
IV	238,581.5	Y4,598.4 12.1%	5,095.5 13.4%	2,413.7 6.3%	18,021.5 47.3%	7,979.6 20.9%	38,108.7 100.0%	16.0%
1986: I	247,360.7	4,466.4 11.9%	4,606.4 12.3%	2,350.6 6.3%	17,875.8 47.7%	8,215.0 21.9%	37,514.2 100.0%	15.2%
II	244,185.3	9,605.0 22.1%	5,226.0 12.0%	1,998.6 4.6%	17,922.5 41.1%	8,806.5 20.2%	43,558.6 100.0%	17.8%
III	255,127.4	12,963.9 26.8%	6,098.3 12.6%	1,965.5 4.1%	19,886.5 41.1%	7,442.1 15.4%	48,356.3 100.0%	19.0%
IV	258,948.5	16,267.4 30.5%	8,028.6 15.1%	1,783.6 3.3%	18,744.3 35.2%	8,445.8 15.9%	53,269.7 100.0%	20.6%
1987: I	371,948.9	16,676.0 30.2%	7,914.6 14.3%	1,867.8 3.4%	21,215.3 38.4%	9,500.0 17.2%	55,305.9 100.0%	20.3%
II	272,591.2	27,003.2 39.3%	9,794.3 14.3%	1,768.8 2.6%	19,944.2 29.1%	10,137.7 14.8%	68,648.2 100.0%	25.2%
III	280,773.5	39,824.5 48.0%	11,678.5 14.1%	1,891.7 2.3%	19,641.9 23.7%	9,915.6 12.0%	82,952.2 100.0%	29.5%

*Deposits from all sources plus certificates of deposit.

Source: Bank of Japan

Finance has tried to placate both sides by giving each something at every step of the reform process. Particularly in the case of new markets, it has given both groups equal or equivalent access. Even where this compromise has worked, as in the proposed financial futures markets for example, the ministry has had to maintain some differences out of deference to Article 65.

Although the ministry has not formally begun to study amending the law, it is watching with great interest the U.S. debate on Glass-Steagall. The fact that Washington has not backed away from reform in the aftermath of the October 1987 stock market crash is seen as encouraging. If the United States should significantly weaken Glass-Steagall, reform of Article 65 will surely follow. Japan's ability to implement the changes gradually, however, is in question. The breaching of this fundamental barrier could easily release a flood of competition that would destabilize domestic markets and begin a shakeout period. Preventing this will be a major challenge to ministry planners.

Financial liberalization has come a fair distance over the past four years -- farther than some expected but less than others hoped. The rapid expansion of Japanese financial institutions has vaulted them into the top global rankings, but they have just begun to meet their potential. Continued reform is the key not only to the growth of Japanese financial institutions abroad but also to the expansion of foreign financial firms in Japan.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.